

Economic Policy Review



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EU Funds, National Budget and Economy

Georgi Angelov

Recently, the European Union funds are a real hit. Every day the information programs of TV and radio stations, the issues of the newspapers and magazines mention at least several times the phrase “European funds”. In principle, there is nothing bad in discussing the spending and control over these funds. The problem is mainly connected to the disproportionate importance attached to these funds, which shows either insincerity, a mere willingness to impress the EU commission, or just a way to escape from the question about the efficiency of the national funds and resources.

EU funds

It is expected that between 2007 and 2013 the Bulgarian government will receive more than 12 billion euro under EU programmes. Of course it is almost impossible, especially taking into account the (negative) experience of Bulgarian administration with EU funds, that all the funds will be used. Probably, no more than 80% of the money will be received (according to some, even 75% is to high expectation).

At the same time, the Bulgarian government will not only receive money from EU, but it will also pay some money in the EU budget. These payments will, most probably, exceed 2 billion

euro for the 7-year period from 2007 to 2013. These payments will need to be done irrespective of the rate of absorption of EU funds.

Not least, many EU programmes must be co-financed by the Bulgarian authorities. In other words, Bulgarian government budget must spend some money in order to receive money from the European funds. It is disputable whether the national co-financing must be considered (partly or totally) as expenditure and whether to cut the value of the net financing from the EU with this money. For our purposes, we will assume that only half of the national co-financing is a cost.

After all these calculations, the net amount that can be expected from the EU budget is about 11 billion leva for the 7-year period.

State budget

In 2006, if the economy continues the current path of development, the revenues of the government budget will reach 20 billion leva. If we assume a moderate growth of the economy and inflation in the next 7 years, we can expect for 2007-2013 period the revenues in the budget to reach about 200 billion leva.

Economy

Without being too optimistic or pessimistic, we can assume that the average nominal economic growth in the next 7 years can be about 8.5%

(3.5-4.5% real growth and the same inflation). Under these moderate assumptions, in the next 7 years the total produced gross domestic product (GDP) will be more than 450 billion leva.

Comparative analysis

In the best case, if we assume full absorption of the EU money, the Bulgarian government can expect 14 billion leva net financing from the EU for 7 years. In the more realistic case the financing is 11 billion leva. Therefore, whatever efforts are put into absorption of the EU funds, the maximum change that can be achieved is 3 billion leva. Moreover, the usage of these funds is limited by many rules, designed to achieve the EU goals, therefore they cannot be invested where Bulgarian society desires most.

As we showed, the government revenues for the same period will be about 200 billion leva, i.e. 16 times greater than the expected EU funds. Taking into account the large share of inefficient expenditures in the budget of the Bulgarian administration, a more intensive policy of control and increasing the efficiency of expenditures can deliver at least 30 billion leva savings within 7 years.

The total GDP in the period 2007-2013 under realistic assumptions about the rate of economic development will amount to more than 450 billion leva. If some more radical economic reforms are made, the rate of economic development will increase by at least 4-5 percentage points, as shows the example of other countries. Such a development could bring a net positive effect for the well being of the citizens

amounting to more than 100 billion leva within the 7-year period.

Obviously, the biggest opportunities for increasing the well being of Bulgarian citizens can be extracted from reforms, increasing the rate of economic growth. About three times lower is the effect that can be obtained through increasing the efficiency of government expenditures. The effect from putting more efforts in the absorption of EU funds is about 33 times lower than the results of increasing economic growth and about ten times lower than increasing the efficiency of government budget.

In the light of these data, the excessive accent put on the EU funds, is not justified. The greatest attention in economic debates must be received by the economic reforms, leading to higher economic growth and reforms that increase the efficiency of government budget. There is nothing bad in discussing the EU funds, but the accent must be predominantly on the economic and fiscal reforms.

Comparative analysis: EU funds, national budget, GDP

| Leva | EU funds | National budget | Economy (GDP) |
|---|----------------|-----------------|-----------------|
| Expected development | 11 000 000 000 | 196 000 000 000 | 457 000 000 000 |
| Possible additional effect as a result of reforms | 3 000 000 000 | 30 000 000 000 | 100 000 000 000 |

Source: Calculation by the author on the basis of data by AEAF, NSI, BNB, MF

Do We Need the Compulsory Minimum Wage Compensation for Years in Service?

Adriana Mladenova

At the beginning of the year 2006, the International Monetary Fund (IMF) raised the question for the abolishment the mandatory wage bonuses in Bulgaria that are defined as a 0.6% of the nominal wage for each additional year in service. The Bulgarian government took the commitment to abolish this regulation in 2004 in an agreement with the IMF. The uprise of the question provoked a number of comments in Bulgaria - in media, on forums and among

politicians. Labor unions made a firm position that the minimum service bonuses should not be abolished and they can be removed only if new mechanisms come into force so that the level of the salaries in the private and public sector can be regulated. In the opposite case, all working people will be "doomed" to low wages, they warn.

The government stepped back and the social minister Mrs. Maslarova said that till the end of the year the bonuses will not be removed. This is hardly a wonder because the Ministry Labor and Social Affairs cannot afford to have its image of social responsibility degraded. The politicians preferred taking a popular decision as opposed

to keeping their promise before the Fund and making a step towards liberalization of the Bulgarian labor market. In policy, it is known, that the winning ideas are those that are supported by socially famous groups and lobbies, no matter whether they represent the majority of the public or whether they are efficient for the business. That is why it is of utmost importance to discuss the government's decisions and comment on the economic impact of the policies that are being conducted.

The Institute for Market Economics stands firmly behind the position that the *legal* minimum compensation should be abolished. However, by stating this we are not agents of the “greedy” employers who would rather not pay the employees for their work. On the contrary, there is a real alternative to the existing policy, which can lead to more disposable income for the people. For this purpose it is necessary (and possible having in mind the current fiscal balances) for the tax burden and the social security payments to be reduced and at the same time the labor market to be “freed” from regulations such as the compensation for service, minimum social security payments for different professions, etc. The low wages are only a consequence of the business environment and the current situation on the labor market, and the imposed administrative regulations do not lead to an affective change and enhanced labor paying. We should not treat the symptoms, but the disease itself.

What determines the wage rates?

Back in the middle of 19 century, one of the fathers of the classic school of economics – Frederic Bastiat – wrote the following: *when two workers run after one employer, wages fall; they rise when two employers run after one worker*. In market economics wages depend on the supply and demand of labor. When there is more demand for labor, the wages grow up and vice versa. This “natural law” cannot be changed, no matter what politicians and union leaders wish and want. The minimum compensation in the wages is just an instrument for redistribution of resources and as such is followed by distortions of the market powers, which affect the behavior of both employees and employers.

Mandatory service bonuses are relics from the past – left from the period of communism when such administrative regulations were the only way to raise the wages to pay for experience,

qualification and loyalty. Nowadays, all these factors are taken in consideration when employee and employers negotiate freely on the market and the central-planning mechanisms only harm workers.

By abolishing government regulations and restrictions, a green light would be given to the market mechanisms. Individual bargaining between employee and employer and a human resource policy on a company level is the most efficient way of deciding on the terms of work. Labor is subjective and every person is unique, his/her capabilities cannot and should not be limited into stereotypes and frameworks.

Now, let's have a look at the effects from the existing wage compensation from the point view of the employee and of the employer.

Employees

- The mandatory bonuses leave the feeling that not the employers but the state is responsible for workers and it should take care of its citizens. The desire to be paternalized from the government distorts the incentives and motivation of people. They have the misleading feeling of safety and are ready to seek their “rights” not by negotiating with employers but by going on strike or abstaining from participation in elections as a protest against the government.
- Instead of being motivated to improve and advance, the artificial compensation works in just the opposite direction – it discourages many people, as these bonuses are a kind of certain source of income. Empirical studies show that minimum wages substantially reduce training received by young workers – both undertaken to qualify for a job or on-the-job training aimed at improving the skills.

Employers

- Some employers recruit young people with fewer years of professional experience in order to avoid paying the service bonuses. Unemployment among the elderly is still high due partly to the mandatory compensation. Many of the elderly, although having a considerable

number of years in service, do not possess some of the qualifications of the young such as computer literacy or the have a profession for which there is no longer a demand on the labor market. So, they cannot compete on equal terms with the young, as their years in service are a burden for them before employers.

- Some employers in the private sector avoid the regulation by paying different nominal salaries to their employees so that the compulsory bonuses would not differentiate them. Some of the regulations for the business in the sphere of labor law and the fiscal burden are among the greatest engines of development of the “gray sector“ in the country.
- Effective programs for motivation of the employees are not 0.6% annual increase of the gross salary for each additional year in service. Thus, there is no room even for competition among employees. Private companies have made up different ways of stimulating and motivating their workers such as bonuses driven by results, opportunities for personal development, creation of valuable business contacts, and personal satisfaction. Focusing of the employer on employees themselves, not upon the regulations of the state (together with the headache to avoid them) will help the workers to much greater extent.

Labor market and efficiency

The mandatory compensation in wages is not a solution to the problems. In economics every event has seen and unseen consequences – incentive distortions and different signals are sent to the market players via the prices of the products and the factors of production. In order for the wages to be increased, the productivity of workers should be increased and there should also be economic growth, which makes the business more optimistic about future, and consequentially, more labor and capital are hired.

One of the arguments in favor of the compulsory service bonuses is that the wages are sticky. That means that they are not affected in the short run by supply and demand of labor and as such,

addition to the nominal wages is needed to correct for inflation, e.g. However, the primary cause of the stickiness of wages is not a market failure. The government regulations, minimum wages, intervention of unions, the labour law make the wages sticky. Bulgaria is in the last places by labor mobility indicator as a result of the heavy bureaucracy and the great number of administrative measures and regulations.

Regulations should be conducted only if the benefits from them are greater than the costs and the negative side effects for people. The possible externalities of the regulations are higher unemployment, decrease of the labor force, growing up of unofficial market. In Bulgaria the unemployment among the elderly people is at considerable rates, the labor force tends to reduce and the unofficial market is still a concern.

According to a study conducted by the *World Bank*, heavier regulation of labor is associated with lower labor force participation and higher unemployment, especially of the young.

Successful relations between employees and employers come from mutual interest, not as a result of compulsory mechanisms and government interventions. When employees improve their skills and qualification, their wages rise as they become more valuable for the company they work for. In this way, people should rely on their own capabilities. In the other case, if we do not trust the market itself, we should rely on the benevolence of the state and hope that the strategies the public officials write are efficient. Unfortunately for those who believe in the government to reduce poverty, the strategies of the central planning do not eradicate the problems and the implementation of these strategies even worsens them.

Establishment of State Export Bank – Does It Have To Be Done?

Dimitar Chobanov

The Sixth roundtable organized by the prestigious newspaper The Economist was conducted in March. During the discussions, the idea for the establishment of a new state-owned bank aimed at a more active and focused policy for promoting the Bulgarian export. The rationale for this suggestion was that the export and import should be balanced.

It seems like the data revision has not relieved the authorities although the current account deficit was substantially lower compared to the previous data. According to the new methodology, the current account deficit was 5.8% of gross domestic product (GDP) instead of 8.5% of GDP in 2004 and 11.9% of GDP instead of 14.9% of GDP in 2005. Resulting from the new methodology, the negative trade balance rose (from 14 to 15.2% of GDP in 2004 as well as from 19.3% to 20.6% of GDP in 2005) and probably has raised concerns among the Bulgarian government officials.

Different ideas addressing the “issue” with the current account deficit were presented during the last few months – increasing the value added tax rate, introduction of import taxes and more comprehensive export strategies. These measures as well as the establishment of an export promotion bank would not have a real effect. National practice shows that different existing state institutions aimed to some extent at stimulating the export. Those are the Bulgarian Export Insurance Agency and the Encouragement Bank. However, according to the government officials, their functions are quite limited and the results are vague.

At present, the number of licensed banks and branches of foreign banks in Bulgaria exceeds 30¹. Apart from this, the possible accession of Bulgaria into the European Union would allow the banks licensed by the other EU members to operate in the country. Hence, if the rulers assess the banking system functioning as unsuccessful,

the entry of new players into the market in relatively short period would inevitably have a positive influence over the bank sector competition.

The operational results of the commercial banks, however, do not support such doubts. Since a massive privatization of bank system was implemented, only the Encouragement Bank is still owned by the state and the Sofia Municipality owns over 50 percent of the Municipal Bank. Therefore, the greater share of the banking system is private and is owned by foreign investors who have experience and skills in banking. Thus, it is hard to believe, that banks operating in Bulgaria would not provide financing for successful projects whether they are directed toward the external or to the internal market.

The development of banking during the last years shows that the credit activity has significantly risen. This activity has even induced a strong reaction by the central bank aimed at limiting the rate of increase of credit volume. According to the author's calculations based on the Bulgarian National Bank data, the long-term credits for non-financial enterprises which are supposed to be the source for the country's export has continuously risen since 2001. The growth is around 71 percent in 2002, around 65 percent in 2003, 49 percent in 2004, and 31.2 percent in 2005 respectively. Apart from this, the interest rate on these loans has lowered substantially from over 13 percent in 2001 to around 10 percent in 2005. Therefore, there is a strong positive development in bank credits.

However, the state or any of its agencies is not the determinant for this tendency. The retraction of the state from this industry is thus proven to be successful and has a clear result. Of course, the international conjuncture should be taken into consideration, which also contributed to a large extent to the growing volume of credits. The other determinant is the increased competition among private banks as well as better management and information systems that allow processing a greater number of credit requests.

In these circumstances, the government interference through the establishment of new bank looks inappropriate. There would not be an

¹ Licensed banks that can implement banking in the country and abroad are 28 and the foreign bank branches are 6.

effect from such a bank. It would probably be used for granting credits with lower than market interest rate for projects that would not be financed otherwise. Hence, the government would virtually lower the economic efficiency directing resources to such projects. This, in turn, would reduce the resources available for other projects. So, the government would support less productive projects at the expense of better ones that could be financed by already existing banks.

One should not omit that the new bank would be capitalized with the taxpayers' money. The presence of fiscal reserve account exceeding EUR 2 000 million is at a great value for the ruling majority to undertake a massive investment program. However, as it was already mentioned, the effect from these measures is rather populist. Their purpose is to show the government's concern for a particular "problem" but they do not really solve it. It is also logical to suppose that this state-owned bank would be used for granting loans to companies related to

the government officials. Hence, it is possible to create a situation for higher corruption. Banking management also would increase the number of palatable positions that could be divided between the coalition partners.

The conclusion from the specified arguments is that an establishment of something unnecessary for the economy is suggested and the effect from this would not be higher export. Instead of establishment a new bank, the government has to conduct measures aimed at better business environment in Bulgaria. Banking is a good example showing that foreign and local investment and the competition lead to positive development and this is beneficial not only for the banks but also for the population as a whole. It was achieved by opposite measures like retraction of the state from this industry. This is the exact way for the rest of the economy – broadened liberty and less government interference.

Bulgaria Real Estate Market – Exciting Past And Steady Future²

Svetla Kostadinova

Development of the real estate market is of great importance to Bulgaria. The construction industry in the country employs a significant number of people, adds value to the economy and thus contributes to the steady GDP increase. On the other hand, the banking industry is more than ever involved in the real estate sector by facilitating mortgage credits to individuals and companies and by offering more flexible conditions, lower interest rates and longer terms. Last but not least, rapid real estate market development attracted huge foreign investments in the country, both speculative and green-field, that accelerated growth of the economy.

What are the main factors for that?

- 1) The economic environment in the country improved significantly in last 5 years – we have one of the lower corporate rates in Europe, inflation is

lower, incomes are rising, predictability improved, economic freedom increased.

- 2) New legislation was passed that facilitated secondary mortgage market and real-estate related investments – introduction of a law on mortgage bonds in 2000 (banks can find additional money for their credit activities), a law on special purpose vehicles in 2003 (companies that can invest in real estate and thus provide opportunity for small investors to put their money in big investment projects), and improvement of Central credit registry within the national bank and start of operation of the first private credit bureau that would allow for greater transparency.
- 3) EU accession is anticipated as a trusted measure for an economy that heads to more stable and secure business environment for investors.

The state's role should be to guarantee private property rights and contract enforcement. Unfortunately, we are witnessing some negative draft laws and intentions in this field that can have contradictory results. Such examples are a draft law on registering construction companies, a draft act on the seacoast, the idea to tax all

² This article first appeared in Sofia Echo Weekly newspaper.

agricultural land in the country, etc. If these are to be implemented we can expect adverse effects on the real estate market.

Transparency and security are very important for this market. The government has received financing from World Bank to create a property register and cadastre. Nevertheless, they are in the process of creation and delays cause problems and leading to a less liquid market. The obstacle for a more transparent market is misreporting of the transfer price in real estate deals. The incentives of hiding are two – due transfer tax (2%) and informal economy (all deals above 30 000 BGN should be reported before the Financial Intelligence Agency for origin of money and this is hard in case you misreported your income because of high social security contributions for example).

Despite all of these circumstances, the property market in Bulgaria has accumulated enormous foreign flows in real estate – starting from 4.7 mln. euro in 2000 and reaching 335.8 mln. euro in 2005. These developments have made people wealthier and provided good investment opportunities.

Major real estate market developments in 2005 and future prospects

Housing market – after the most successful year (2004), 2005 was characterized by steady housing construction, higher prices, friendly banks and willing customers. Although, price inflation was less aggressive, we witnessed increased prices in several secondary markets in the country (Stara Zagora, Pleven, Blagoevgrad, etc.) as a result of catching up with business development. 2006 will be less profitable for construction entrepreneurs (more time to sell finished apartments, demand for more flexible payment schemes so to be competitive, higher quality demanded by customers, increased land price).

Vacation (apartment) buildings – the boom in construction of such buildings was dominant in 2004 - 2005 with major destinations summer resorts (Sunny Beach, Golden Sands), as well as winter destinations (Bansko, Pamporovo). Bad infrastructure, lack of commitment and control from local municipalities is on its way to turn these places into overbuilt cities where no decent return from investment can be achieved. That is why, one should be careful when considering investing money into this. Anyway, other

destinations inside the country gather momentum and are likely to be very profitable and attractive.

Land – one of the major characteristics of land market in Bulgaria is the existing ban of foreigners to acquire land in the country. However, this is not considered as an obstacle but increases transaction cost, time for concluding a deal and involves intermediaries. In any case, this gives the chance for many low class families to sell their land at higher price. We can hardly say that there is a dynamic land market in Bulgaria except for big cities and resorts where major construction activity is concentrated. Agricultural land is still less attractive. Despite this, several specialized land investment funds were created so we believe that this market is just starting its real development. Still, land investment will require long-term commitment and is less liquid.

Office market – starting to be very dynamic in the capital and expected to be of greater attention for investors. “Specialized” in such investments are special purpose investment companies that accumulate funds from smaller investors, invest them in big projects and manage the property for number of years. Since demand for specialized, high-quality office buildings with additional services is accelerating we can expect that many entrepreneurs will be attracted in this segment. Since more and more companies are willing to build their own offices and then sell and lease back we can expect future development.

Industrial market – it is concentrated in several areas in the country (Sofia, Plovdiv, Sevlievo, Bourgas) but more cities are making efforts to attract big companies. Accelerating the decentralization process in Bulgaria will give powers to local municipalities to offer competitive business environment and stimulate new investments. The process however is slower than desired. Land prices, the urbanization process and local authorities willingness to assist business are deemed as incentives for big foreign companies to invest.

Trade market – every time an economy is growing trade properties are on the edge of investors’ interest. With rising incomes, the consumer confidence and purchasing power are increasing and this inevitably rises spending. 2005 was the year when several big trade centers were started and expected to be completed in 2006. The so-called malls are registering huge

investors interest and all units are pre-sold entirely. Sofia, Varna, Stara Zagora are the cities that attracted such projects.

Property as an investment – price inflation of all types of property (except for land) turned real estate investment into a very profitable endeavor. Bulgaria was among the few countries in Europe that secured a property investment return of above 9% - 10% in 2005. The picture is changing slowly in downward direction but is still attractive for investors. Lower levels of European interest rates attract less speculative investors as ordinary foreign citizens and companies. The trend however is for steady flattening of Bulgaria's property returns with European levels in next 3-4 years.

Sofia – capital property market should be analyzed separately from other locations since it differs in many ways. First, housing demand is more dynamic and constant that is due to in-country migration, higher incomes, headquarters' location of almost all international companies, good investment prospects, etc. That is why housing prices rose permanently with the changing of preferred districts in time. Central

locations are still of interest but high-quality residential complexes with restricted access in the outskirts of the city are attracting customers. They offer European quality construction, additional services, property management, security and comfort to its buyers. At the moment, wealthy people are among the major customers but we are witnessing a change in customers profile since middle-class buyers are supported by banks in such transactions. Office buildings in Sofia are soon to become the most attractive type of construction. EU accession and positive expectations of business facilitate investment in real estate for their activities. Although rents lagged behind in 2004 and 2005, we see an increase of their levels that should continue in 2006 if no major political downturns happen. Construction of two malls and a lack of free trade space are no surprise.

As a summary we expect that the real estate market will further develop with less intensity in its housing and vacation apartments sectors, and with a future focus in office and land segments.

An Aide Memoire on the Perils of Protectionism

Kevin P. Allen

Shakespeare once said: "That which we call economic patriotism by any other words would smell as sweet." Perhaps those were not his exact words but irrespective, his premise was correct. Protectionist policies employed by European countries as of recent do indeed smell although sweet is probably not the best adjective that could be used to describe the smell.

In Europe, particularly in the energy sector, economic nationalism (read protectionism) seems to be on the rise. For example, the recent EUR 72 billion merger between the French energy companies Gaz de France and Suez has brought criticism allegations of government interference from the Italian government. The Italians argue that the union between the French companies was designed to hinder a potential hostile takeover on behalf of the Italian firm Enel SpA. The French government, which now owns approximately 35% of the new company, argues that they are not endorsing protectionist

policies but rather promoting 'economic patriotism'.

Further examples of such policies can be found in Spain and Luxembourg, among other places. In Spain, the power company Endesa rejected a EUR 29.1 billion bid by German firm E.ON suggesting that the bid did not 'adequately reflect the true value of Endesa.'³ The bid proved to be disconcerting to the Spanish government who sought to obstruct the merger via the invocation of a 1999 Spanish law that gives authorities the right to block companies in which a public body has an interest from taking a stake exceeding 3.0 percent in a Spanish energy company.⁴ The European Commission has proposed that Spain be brought before the European Court of Justice for its' actions.

Protectionism again reared its ugly head when Indian steel company⁵ Mittal Steel, the world's largest steel producer, attempted to takeover Arcelor with a EUR 18.6 billion bid. The

³ www.uk.biz.yahoo.com

⁴ "EU to sue Spain over 'illegal' energy merger blocking law – www.zeenews.com.

⁵ Although Mittal Steel is an Indian owned firm, it is registered in the Netherlands and is therefore bound by E.U. regulations.

government of Luxembourg, who owns a 5.6 percent share in Arcelor, responded by asserting that the 'hostile bid by Mittal Steel calls for a reaction that is at least as hostile.'⁶ The reaction consisted of passing legislation which would make it easier to fend off unwanted takeovers. In response India's commerce minister, Kamal Nath, has argued that opposition to the takeover is the result of racial discrimination and has gone out of his way to remind E.U. members of their WTO obligations.

I could go on and discuss how the government of Poland sought to disrupt a merger involving Italian banking leviathan Unicredit and Germany's HVB bank but the point has been made relatively clear: **Europe is witnessing a resurgence in protectionist policies.**

While one could make the argument that efforts to protect national interests are carried out in concern for the state and its people, the bottom line is that such behavior is diametric to the E.U. notion of a free and open market and counter-productive in the context of international trade. Economic nationalism is not in the best interest of governments or consumers as it has the potential to:

- Diminish the potential value of firms. *The Economist*⁷ reported increased deal activity (roughly 50%) in all major European markets in 2005. In the form of mergers and acquisitions, this increased activity is, at least in part, a function of corporate profits. Government intervention retards the economic growth of corporations and devalues stocks owned by shareholders.
- Lead to sub-optimal performance. By barring productive firms from acquiring those that are less productive, economic nationalism leads to sub-optimal corporate performance. Efficient firms are efficient because they eliminate stagnant and unproductive components of the firms they acquire.
- Diminish foreign direct investment. When national governments interfere in private business deals, foreign companies become reluctant to invest. Undoubtedly, situations such as the ones in Spain and in Luxembourg will push

firms to look toward more liberal markets for investment opportunities.

- Inadvertently lead to increased unemployment. For example, in the early 1980's the United States placed import quotas on the auto industry. As a result, the average price of an automobile rose almost 41% over 4 years.⁸ Although the goal was to save American jobs, the higher prices of automobiles led to significantly decreased sales and consequently, numerous job cuts in the auto industry.
- Distort prices. Tariffs, subsidies, and non-tariff barriers ultimately result in higher prices for goods and services. One need only look to the Common Agricultural Policy (CAP) for an example as E.U. consumers are paying roughly twice as much for their food as they would without the CAP.⁹

After delineating some of the negative aspects of economic nationalism, it seems judicious to reiterate some of the advantages associated with free trade. In this context the term free trade is used to identify trade policies free of any form of government interference.

The most obvious advantage of free trade can be seen in the form of **economic growth**. Data from developing nations (between 1970 and 1990) shows that countries with open trade policies registered a 4.5% growth rate while those with closed borders registered a growth rate of only 1%. During the same period, the GDP of the open countries grew by an average of 2.3% while the GDP of the "closed" countries grew by only 0.7%.¹⁰ To use the United States as an example, a University of Michigan study shows lowering global trade barriers on all products and services by even one-third could boost the U.S. economy by \$177 billion, thereby raising living standards for the average family by \$2,500 annually.¹¹

Another advantage of free trade is that it **creates jobs**. While some might argue that such policies result in the loss of American jobs, evidence from the North American Free Trade Agreement

⁶ "India reminds EU of WTO obligations in steel battle." – www.euobserver.com

⁷ "Europe's nascent merger boom" – 9/3/2005

⁸ "The Myths and Realities of Trade Protectionism." – www.heritage.org

⁹ "A New Agenda for European Agriculture: A Radical Proposal." – www.timbro.se

¹⁰ "The Benefits of Free Trade." – www.ncpa.org.

¹¹ "International Trade." – www.whitehouse.gov

(NAFTA) suggests otherwise. Opponents of free trade argued that the implementation of NAFTA would result in the massive loss of blue-collar jobs in America however since its inception more than 14 million new American jobs have been created, unemployment has fallen from 6% to 3.9%, and the number of manufacturing jobs in the U.S. has remained stable at roughly 18.4 million*.

As well, free trade **promotes innovation and competition**. By encouraging competition, free trade of goods and services forces companies to be innovative and create better products for lower prices in order to retain their market share. One example of the benefits of competition can be seen in the airline industry. In 1975, the airline industry carried about 200 million passengers where as currently the industry carries almost 600 million passengers a year.

Free trade also **fosters the strengthening of infrastructure while helping to develop of a variety of institutions**. Infrastructure development comes via the construction and maintenance of ports, airports, and highways while institutional growth can be seen in the expansion of the banking, financial, and insurance sectors. Free trade also reinforces the rule of law as in order to enforce contracts and protect transport vessels, trading countries must have stable police forces as well as strong judicial systems.

Some analysts and scholars argue that free trade **promotes peace**. Erich Weede, of the University of Bonn, contends that a number of quantitative studies provide evidence of a causal chain running from free trade via prosperity and democracy to the avoidance of military conflict. Citing research by prominent political scientists

such as Susan Stokes, Carles Boix, and Seymour Lipset, Weede argues that 'trade underwrites democracy and thereby the democratic peace where it prevails.' One cannot extricate free trade from democracy and it would be remiss to completely ignore the relationship between free trade, democracy, and peace.

These are just a few of the obvious benefits resulting from free and open trade practices. Most industrialized nations engage in protectionist policies at one point or another however the recent upsurge in economic nationalism in Europe is cause for concern as it has the potential to become self-perpetuating.

The appropriate course of action would be to recognize and accept the fact that, in an economic context, the world is shrinking quite rapidly and 'economic patriotism' ultimately does more harm than good. There is no longer room in the global economy for countries such as France to endorse takeovers when French companies like Vivendi Universal buy out foreign firms such as Seagram and Houghton Mifflin and then later reverse their position when a foreign firm such as PepsiCo seeks to takeover Danone. The pitfalls of protectionist policies are well known however it has become quite apparent that they can sometimes be forgotten. Thus I give to you this brief reminder.

* "The Benefits of Free Trade: A Guide for Policymakers." – www.heritage.org

** "Why America Needs to Support Free Trade." – www.heritage.org.

** "The Diffusion of Prosperity and Peace by Globalization." – www.independent.org.

Social Responsibility and Business Success

Are terms contradictory or their co-existence is by all means possible?

Veliko Dimitrov

Probably most of the answers would turn out to be positive. Anyway, the mechanisms that would be involved in explaining the connection between social responsibility and business success would be different, possibly, differing from each other significantly. I would like to call

the attention to the main, in fact, diametrically opposed approaches:

- **Pro-market:** Successful businesses (e.g. companies, undertakings), even if they do not aim to inevitably fulfill a social function by making following contributions: creation of working places, paying taxes and employers' insurance, striving for producing goods and services with higher quality at lower prices. That is a perpetually working mechanism on a natural basis.

- Socialist: Main role of the government is to carry out social programs (many activities are not defined as “social programs” but in fact they are), redistribute wealth and thus fulfill social functions.

But it costs something and since governments do not create money¹² and at the same time have the authority to tax and collect money, they need to take it away from someone. Thus you cannot get something from someone who does not have it or has not produced it, you must take it from those who have worked for it – successful businesses or successful workers. Imagine you were the government; afterwards you can redistribute the collected money and direct it to wherever you think is appropriate. According to the socialist approach that is the very just co-existence between social responsibility and successful business. The more money is taken away and ready to be “invested” in sociality, the better. Here that is to be accomplished on an unnatural, compulsory basis.

One of the many ways to fulfill a social function according to the socialist ideology is subsidizing state companies, i.e. covering losses they have produced over the year with money from the state or municipal budget. A typical case here has always been the Bulgarian State Railways (BSR).

How is the company doing?

For the first three quarters of 2005 BRS have incurred losses of over EUR 13 million¹³, which is about EUR 4 million higher than the same period of 2004. Over the past three years the company has suffered financial losses of over EUR 50 million.

Short-term liabilities exceed by over EUR 37 million the short-term assets – company undergoes a serious liquidity crisis. The owned capital of BSR as a percentage of its assets is slightly over 3 %, i.e. the company does not dispose of its own resources and is working on credit. Paying back the principal and interests would additionally burden it and lower the profit (if there should be any profit at all) or increase

losses – respectively the money that has to be taken away from the budget to prevent company going bankrupt.

What are the tendencies in provided services?

Over the past 15 years (1990-2005) the number of passengers has decreased by over 67 %, covered kilometers, by over 70 %. For the same period there has been a similar drop in hauled loads – 68 % and covered kilometers have dwindled by over 63 %.

Over the last decade the company has been shrinking by an average 4-5 % annually, which is a clear indicator that customers are no longer attracted to provided services at that quality and price. We believe that there are no preconditions for achieving a breakthrough and an upward trend.

Anyway, there is a positive sign: BSR are no longer going to cross-subsidize the transportation of passengers by using resources of the still financially sustainable part of the company dealing with hauling loads. It is a step in the right direction – towards market-oriented decisions of the management. Thus, if there are no passengers to buy tickets, but firms willing to buy transportation of their loads, the latter would probably get a service higher in quality if the company reinvests part of the profit in improving the respective capacity and facilities.

Although this is a step in the right direction, it does very little to solve the main problem – the company is owned by the state and is being managed more or less by government decisions. In addition, accumulated losses will be further covered by the state budget.

We expect that in future the company will continue losing capital, while the management policy within the company would probably remain the same and unnecessary expenditures, not directly connected to the company's profile would not be cut off. For example BSR are maintaining:

- 3 sea-based rest homes
- 5 mountain-based rest homes
- 2 sanatoriums

Holding up expenditures like these would definitely not help the company out of the financial crises, much rather the opposite – will

¹² In narrow sense, solely banks create money. It is about the creation of additional value, wealth.

¹³ Source: BSR's website - www.bdz.bg

deepen it. That would not be so bothering if the company was a private property and the responsibility for potential losses was fully to bear by and at the expenses of its private owners.

In the case of BSR, the government should sell its shares and totally withdraw from the transportation sector, which is and will keep

growing even faster with at least one more private player, which could be the privatized BSR of today.

The fulfillment of social responsibilities will be then transferred to where it belongs and carried out on a natural basis.

Gypsy Contribution to Prosperity in Bulgaria's Late Communist Era

Krassen Stanchev

Introduction

The key difficulty today in the EU and in Bulgaria's thinking about Gypsies is that almost nobody thinks of them as normal individuals.

They are perceived by different government and Brussels programs as, on one hand, "betrayed and oppressed" (in the human rights rhetoric), "isolated", "ostracized", "segregated", "discriminated" or as, on the other hand – by left and "right" alike, "rough", "stealing", "under-culture", "non-civilized" and even "not-subject-to-civilization", to refer just to a few of the Bulgaria public opinions, somewhat subtitled clichés.

Respectively, the required policy "towards them" should be one of "inclusion", "integration", "rehabilitation", "support", "education" and "protection". This is the vision of the said programs, including private and quasi-government, UN and EU charities. The common denominator of all these definitions is taking Gypsies, or Roma as a class, as category of the population but not as individuals.

Alternatively and again reading Roma as a class, although not quite politically correct, a part, a minority part – to say the truth, of the public opinion in Bulgaria¹⁴, Czech Republic, Slovakia

and Serbia or Kosovo believes that Roma are the societal "bad guys", those who steal, who are per se criminal, relief seekers, welfare users and basically under-class and under-dogs. But this thinking too takes Gypsies as a group, ethnic entity or a class; and the feature prescribed to the groups would be immediately applicable to individual Roma, whatever he or she does.

I can deliberate only on the Role of the Gypsies in Bulgaria. In the three parts of this paper I will make an attempt to discuss how representatives of the Roma contributed to the prosperity under Communism, how they helped create Capitalism (a role that stems from Communist times) and what was and still is the role of Roma in shaping Bulgaria's democracy, culture and policies. I start here with the late Bulgaria Communist years, reviewing some exclusive benefits no one in the country could supply but Roma entrepreneurs.

Second hand clothing and cooperative agriculture

Before 1980, the city Roma craftsmanship were rather typical: blacksmiths, chimney-cleaners and specialists in repairing lead and non-ferrous metals articles. Old Gypsy men, however, had an unique profession – they were purchasers of second hand clothing, wandering around towns' better off neighborhoods on weekend mornings, shouting "Old Cloths 'Buying'".

In those years the second hand clothing exchange was functioning only among relatives; in Bulgaria, almost like everywhere, they used to

¹⁴ Putting Bulgaria first is no accident or alphabetical order of countries. Bulgaria has the largest share of Gypsies in the citizenry, perhaps, around 7-8% of the population, and it has a party represented in the legislature that campaigned with a slogan (among other slogans) "Gypsies – on Saturn!", which in Bulgaria sound like "Gypsies – on Soap!". (The word for "soap" in Bulgarian is "sapun" – from Turkish; so, when "Saturn" shouted sounds as "soap".) In reality, according to anthropologists and sociologists – Bulgaria anthropologists are really very good by any scientific standard, especially on

Gypsies – the Roma in the country are very different: few them are nomads, many are Muslim, quite many but somewhat less are Protestant (in the biggest but not only in the large cities) and or Catholic – located *en mass* in few regions, and some are Greek, perhaps Vlachs or ancient Romanians, blond and specializing as sheep breeders. Altogether there are eight distinguished groups of Roma in Bulgaria, distinguishable in culture, habits, religion and appearance.

exchange baby and kids' dress. Those were times of widespread shortages. Re-making adult clothing was still somewhat popular, but that was the market for professional tailors while many people, not female but male, including myself, were capable of performing simple tailoring and had respective sewing machines at home.

The very old clothing, however, that was in demand among Gypsies only; no one would give cash for that in the 70's and the 80's of the last century.

In the 1990's, selling second hand clothing had become a formalized and even international business.

As far as I could recall,¹⁵ in the agriculture nomad Gypsies were welcome seasonal workforce. The eagerness of cooperative farms to hire them was motivated by the chronic shortage of farm workers, especially because pupils and students were creating more mess that value added in the fields and gardens. There was no discrimination: the day pay was equal to the normal one, the difference between urban "brigadiers" and the Roma was that the latter could work and actually worked hard, to support the family.

Early birds of market economy

Management of independent supply channels of forged or smuggled goods in time of shortages, however, was the true employment for the city Gypsies in the late of the 1970's Bulgaria and the capital city of Sofia in particular.

It was preceded by the liberalization of movement of people in ex-Yugoslavia (after 1965) and the spontaneous open-air market for consumer goods and fashion articles at Sofia St. Alexander Nevski Cathedral Square, the very heart of the downtown area. Yugoslavs were trading those articles, music plates and magazines, erotic journals and anything one would imagine or desire. That market expanded during the World Communist Youth Festival of 1968, which took place two – three weeks before Warsaw Pact troops invaded Czechoslovakia. Suddenly, it practically declined and moved to

another location in 1972 when Belgrade and Nis (a town in Eastern Serbia) bus stop was moved to the outskirts of the city.

On the Alexander Nevski Square "black market"- as it was called then although it was virtually the only normal market place in town, the Roma did not compete with Bulgarian spontaneous merchants who wanted to buy and resell to the local thirsty public; they wanted to sell to ex-Yugoslavs things that were much cheaper (subsidized) in Bulgaria – milk and milk products, cheese, etc. The Roma were saving the ex-Yugoslavs the costs of walking around empty shops, of queuing and other unpleasant experiences.

Gypsy foreign exchange

How only very few would remember that in the Communist countries there were special shops where foreigners, tourist, diplomats and privileged domiciles alike could spend their hard currency. In Bulgaria they were called "*Korecom*" – from "currency commerce", thus indicating that local "money" was anything else but currency.

The supply channels of valuable goods managed by Roma entrepreneurs merged in relation to "*Korecoms*" and paralleled them. They flourished and prospered especially after the "*Korecom's*" liberalization of 1977 that consisted in the fact that the government suddenly stopped asking questions about where the public has the hard currency from. Of course, nothing was certain but, obviously, the Communist planners needed dollars, D-marks and every other useful cash for the big ideas they had and it was easier to collect from the public than borrow through official channels.

The circumstances were the following:

- The fear of visiting those shops¹⁶ did not disappear; many people, however, were trying their best to overcome it;
- The demand for hard currency had risen; the official exchange rate to the US dollar was about 1:1 but on the free market it was 3-4 to 1, often higher for

¹⁵ My Western friends may not know that in my and other Communist countries big, virtually all groups of urban populace was required to "[volunteer]" few days or a week per annum to work in the agriculture; pupil and students "volunteered" at least a month.

¹⁶ Beside "*Korecoms*" there were shop chains for those who possessed Russian ruble denominated coupons (those who worked in the Soviet Union) and shop for sailors, but in those shops buyer were required to identify themselves or source of the money – not always but often.

Soviet Union (the shortages there were much more severe and unbearable) and/or for smaller quantities;

- An organized but informal market for goods demanded against hard currency emerged.

The Sofia Gypsy community services in this situation were very much the ones at a state of the art:

- Forex trading;
- Import of most demanded goods – jeans, cloths, cosmetics, modest and easy to carry devices like radio, tape recorders, gramophones, sewing machines, skis and ski boots, etc.;
- Diversifying the intermediation depending on the conjecture and the good at demand;
- Visiting the shop for instead of the frustrated buyer.

The money markets were located in front of the “*Korecom*” shops to serve desperate shopping public or smartly downtown, in front of the Central Department Store – next to the Council of Ministers building and across the square from the president’s office. It was rather clever to meet disappointed customers of the Central Department Store when they walk out empty-handed and offer them some alternative to buy what they wished.

The currency trader would usually ask what the good the unfortunate needs to buy is. If it was clothing, jeans or any other of the above said goods, the Roma entrepreneur would usually offer a better price than the official currency shop if it was to be bought at another location”. If it was skis or something that would be relatively difficult and risky to store, the service would be to buy that rather expensive piece at the hard currency shop instead of the customer but in his/her presence to help with his or her fear of being asked about the origination of the hard currency.

The “other place” used usually to be the Gypsy neighborhood at the outskirts of the city, the taxi (another good subject to severe shortage then) was readily available, often at the expense of the seller. The goods were usually stored in a relatively well-to-do house. The quality was expected to be the same as in “*Korecom*” and one could try the cloths that were properly

packed and labeled. The taxi would save time to go there and back, if the purchase was significant and the company pleasant the merchant would pay the taxi. The transaction should be executed in hard currency, which usually was to be exchanged at the separate vendors.

I am not aware of a single case of fraud. In comparison to the trade in the “*Korecoms*” and especially to the exchanging money on the street with Bulgarians, the risk was zero. The militia in front of the Central Department Store would witness what was going on but would not interfere. The Roma vendor would, as a rule, know the cap.

Servicing the customer

In all three cases there is one very significant role of the Roma entrepreneur: he (women were not involved) was helping to overcome severe shortage of the Bulgaria’s Communist economy.

In the shortage economies witness a very widespread phenomenon, the consumer surplus was driving the prices like in normal economies but with some excesses.

Thanks to the controls and oppressed competition, the consumers valued some goods far beyond their price under other, normal conditions. That price paid would appear high relative to the opportunity costs or compared the wages and income.

Some examples: in 1977-1979 a pair of jeans in “*Korecom*” could typically cost from 21 to 27 US dollars and the price was equal to 1/5 – 1/4 of the average salary. But outside “*Korecom*” the jeans price would be most likely 35 – 40 US dollars. With the Gypsy jeans vendor the pair price was equal to the one in the shop or often a little bit less. The same was the case with other desired goods.

In other countries, the constellation was similar but there were no Gypsies involved in the trade. In some countries it was even more desperate but provided for normally unthinkable arbitrage.

In Leningrad, today’s St. Petersburg, the price of a pair of jeans in 1977 – 1979 was 125 US dollars – almost two times the average salary. In the Soviet city of Togliatti one could sell a pair for US 250 dollars. It was four times the average salary but two times the average wage in that city since it was producing *Lada* – for those who do not know, it was the Soviet car being sold

throughout the countries of the Eastern Block. But the circumstances could endlessly differ in details. For some reason, in 1975, Leningrad authorities banned Finnish tourists of using their own currency in bars and the Soviet analogue of “Korecoms”, limiting also the amount they could exchange officially. Poor Fins could exchange their money at 0.25 of the rate they would otherwise get on the unsuppressed market. Then, in Finnish currency, perfectly usable on the hard currency market in Bulgaria and elsewhere, the pair of jeans could cost in fact about US 7-94 dollars and be sold in Leningrad or Tolliatti.

In 1960's and 1970's people were not looking just for bread and butter but for something more, beyond the established and planned basic needs.

How did the Gypsy entrepreneurs used to fall in the picture? They served the consumer. Many Bulgarian students in Soviet universities, actually thousands of them, lived better than many ordinary Soviets and Bulgarian for years.

Contribution to prosperity

The Gypsy entrepreneurs have been helping ordinary Bulgarian citizens for years doing what the system was not providing or was even fighting against.

In the described three cases we have obviously dealt with:

1. Exploring and developing a market for goods and services for which even an attempt by the majority representative

would have been punishable or morally condemned but which allowed Gypsies help others in receiving what they wanted;

2. This activity had nothing to do with the social welfare system of that era and the Gypsies involved were helping themselves much better compared to what they could have gotten under the welfare;
3. Not only the flexibility of income but also the mobility of labor was secured under Communism with the Gypsy assistance. It was especially visible in the agriculture;
4. Being an intermediary or an entrepreneur was a crime during the Communism, Gypsies obviously managed to counteract the ban and serve the consumer surplus of many individuals, whose rights as customers were systematically oppressed by the government.

Needless to say, in all three cases these activities were performed not only by Gypsies. The important point, however, is that they were doing this on a more massive scale and as a profession. There would be no exaggeration to state that in the Communist Bulgaria of 1970-1980's it was the single largest segment of the population that was living in and intermediating niches of the free market under oppression of the central planning.

IME Awarded 2006 Templeton Freedom Award



In February 2006, the Institute for Market Economics was recognized as a winner of a 2006 *Templeton Freedom Award* Grant out of over 80 institute applications from all over the world.

The *Templeton Freedom Awards* is a program run by Atlas Foundation (www.atlasusa.org) that rewards thinks tanks that are making the greatest contributions for promoting freedom as well as those with the most future promise.

IME's *Economic Policy Review* won the prize because:

1. It has been pioneering public debate of topics and issues of immediate or long tem concern such as: first surveys of transaction costs, informal labor and informal economy in Bulgaria and the Balkans, on mortgages, business environment and costs of dealing with the government;
2. Over 200 draft laws and regulations were assessed in the bulletin;

3. The average reprinting rate of the newsletter is 80% for 2005 and we expect it to pass 90% in 2006 as it is gaining popularity.
4. It disseminated methods of basic economics and cost-benefit analysis;
5. The *Economic Policy Review* produces supporting materials for other IME websites and print product, e.g.: the EU accession sub-page (the most visited part of the IME Web), the educational page of the Economics Access Station of Internet (www.easibulgaria.org), the flat tax bulletin and the website (www.ime.bg/flat), the monthly bulletin goes to the desk of every MP and a minister), the cost-benefit analysis (www.ria-studies.net), the web page of mortgage finance and real estate (www.ceemortgagefinance.org and its more popular Bulgarian version), the sub-page on welfare reforms, etc.
6. We have introduced to the Bulgarian audience via *EPR* and EASI a great number of unknown economists and writers, some of them have already become relatively popular, e.g. Bastiat, von Hayek, Menger, von Mises¹⁷, Curzon-Prize, Lee, Gwartney, Stroup, Swanepool, Pejovic, Paul Belien and others, to mention just a few.
7. We were the first to publish the Magna Carta in Bulgarian, and via *EPR* highlighted topics of economic history.
8. *EPR* had made IME associates very popular. This helped some of them successfully run for parliament with one colleague during the 2005 parliamentary elections being the most televised, interviewed and printed candidate (entering politics anew and being more popular with the media than former PMs, finance ministers, and the like).
9. There are more than 3,000 e-mail addresses subscribed to the *Economic Policy Review* in Bulgarian. The traffic of the sub-page of the bulletin (http://ime-bg.org/pr_bg/) amounts to an average of 5,000 visitors per week. Thus, the circulation of the newsletter exceeds many of the established daily newspapers in the country. The newsletter is extensively quoted and cited by journalists, economists, and broadcasters.

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¹⁷ At the time we published them, there were no translations in Bulgarian.